DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

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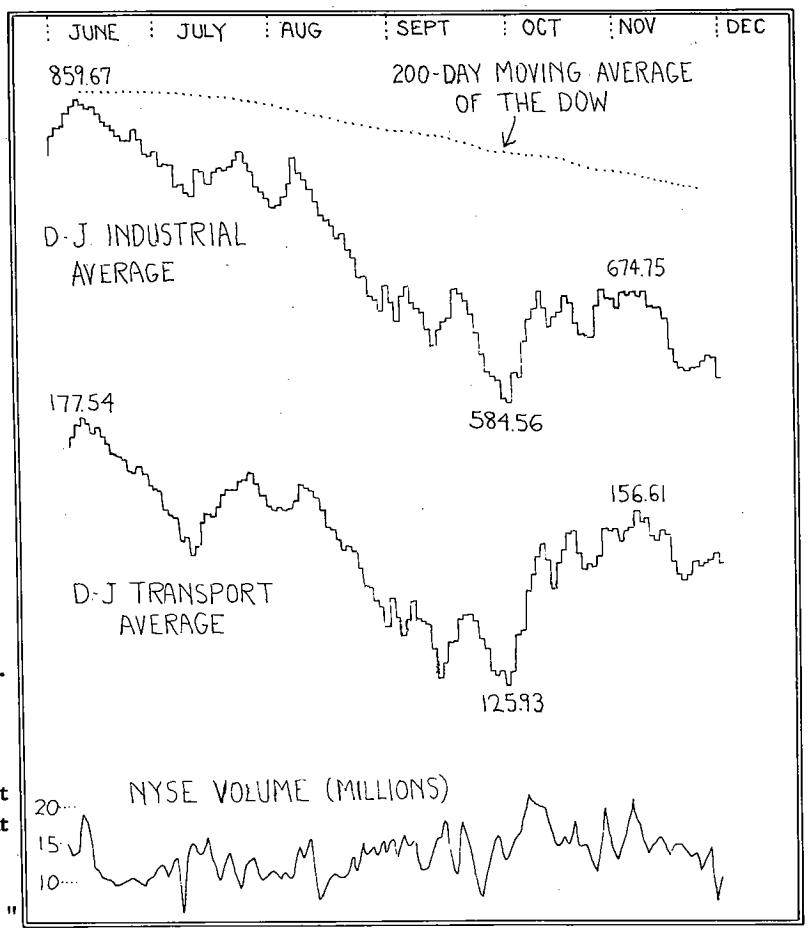
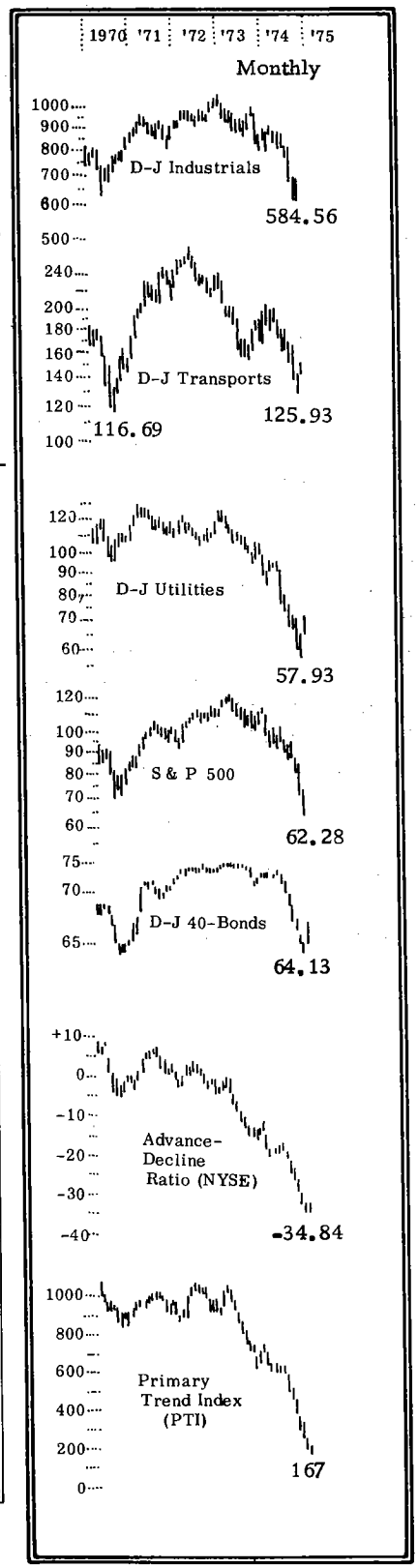
THE MARKET: I am amazed by the tone of certainty in the majority of financial services which arrive here (and I must read thirty or more per week). It took me years of reading (and following the various individual track records) to realize that no one man has "the answer". As a matter of fact, I have come up with a little theory of my own (which may sound cynical, but isn't) and it runs this way, "Watch the man who has been right about the market over a considerable period of time. He has a high probability of being wrong on the next major turn." The corollary to this is, "Watch the intelligent analyst who has been wrong about the market for an extended period of time. Don't write him off; he will probably be right on the next major turn." Any business in which you can make that kind of observation has to be a tough one!

If you deal with investments long enough, you will either get humility or go broke, and I don't care if you are a market letter writer or an investor. Robert Rhea, the leading Dow Theorist of the 1930's, was the finest interpreter of market action I have ever come across. Often, I take out my dusty copy of Rhea's reports (written 1932-39) and re-read a selection or two. Yesterday, as I followed my old reading habit, I was struck by Rhea's words regarding certainty. On July 3, 1934 (two years after he had called the exact bottom of the greatest stock market collapse in history, he wrote, "Quackery can usually be detected by the positiveness of pronouncements. Those who have attained a bachelor's degree are never so cocksure."

A year later, on July 6, 1935, he wrote, "Those who profit by the advance and decline of security prices are perplexed perhaps 90% of the time, and it appears the perplexity increases with experience. It has seemed to this writer that unvarying cocksureness on the part of traders and investors or investment advisors is a badge of incompetence. There is, nevertheless, a place for certainty where the market is concerned, but such times and places are few and far between."





 With that introduction, I am going to move into a rather lengthy discussion. During the course of this discussion, I will announce a change in my basic attitude towards this bear market. First, the discussion: for eight years, or since 1966, I have been stating (1) that we are in a great primary bear market, (2) that regardless of news, hopes, Acts of God, Governmental intervention, inflation, wars or anything else — the Averages and most stocks are going much lower, (3) that in a primary bear market, correct procedure dictates that we be out of all common stocks (golds excepted) and in cash or its equivalent (Treasury bills, notes, etc.).

All major bear markets have produced three identifiable phases. These phases are based on investor psychology, not price movement (although in many cases the price movement and the phases do coincide). I identified the February to October, 1966, period as the first phase of the bear market. This is the phase in which the market declines as it erases the froth and frenzy of the preceding bull market's final upward thrust.

I identified the second phase of the bear market as beginning in late 1966. This (second) phase is the one in which the market goes down as it discounts deteriorating economic, social and political conditions for stocks. Traditionally the second phase is the longest and most deceptive phase. The extended, treacherous second phase of this bear market certainly lived up to tradition. The second phase lasted eight years, it almost broke Wall Street, it totally ravaged the assets of the American public, and it pulverized the institutional portfolios (and their managers).

In Letter 613 I wrote that in my opinion the second phase of the bear market had ended. It ended on October 4, 1974, at 584.56 on the Dow Industrials. I also opined that from wherever the rally from the October 4, 1974, lows ended, the third and final phase of the bear market would begin.

The third phase of a bear market represents the liquidation phase. It is here that stocks may be sold under the most painful and urgent conditions. The underlying reason behind third phase selling is that men and institutions need to raise money, thus the usual involuntary liquidation. During the third phase stocks traditionally go "below known value". A characteristic of the third phase is a final collapse in the blue chip issues. The reason is clear enough: the blue chips will command a market when many other issues have no market worth talking about. The man who has to raise $1 million can do so on any day of the week by selling duPont or Alcoa. But presently, for instance, one-third of all the over-the-counter issues have no market at all, and this dismal situation will probably deteriorate even further as the third phase moves into full flower.

I list below some of the classic characteristics of a bear market's third phase, a sort of "major bottom checklist": (1) Good stocks sink below statistical or appraised value, and the investment grade D-J Industrials may yield (on average) 6% to 10% or more. (2) Speculative sentiment in the stock market declines drastically to the point of almost total disinterest. (3) Volume on the exchanges is far below that which existed at the preceding bull market high, perhaps as much as 70% to 90% below. (4) Market psychology is extremely depressed. One hears such expressions as, "You'll buy 'em at half these prices," and "Wall Street will never recover," or "The nation is going under along with its securities." (5) This particular criterion is of utmost importance: the market becomes immune to bad news. Shock after shock, depressing black headlines, Cassandra-like predictions, all fail to drive the Averages to new lows. At this point the market should be at the approximate final bottom.

Those are some of the phenomena which we will be (and are) looking for as we move into the third phase of this bear market. They are all signs of THE bottom. Will they all occur at the bottom of this bear market? Of course they won't, at least not in classical or "perfect" form. The stock market never gives you exactly (or even approximately) what you want. If it did, market analysis would be a science, not an art (if you still think it's a science, ask some of the computer boys at the banks how they did over the past few years, that's if they're still around!).

"All right," you reply, "I've read what you asked me to read. But what's the 'new attitude' that you are talking about, Russell?" My answer is that from here on, I'M PUTTING THE MARKET ON ITS OWN MERITS. THE MARKET IS GOING TO DO MOST OF THE TALKING INSTEAD OF RICHARD RUSSELL. You see, I've been dead bearish on this market for eight long years. I've had to sweat, argue with myself, argue with my cohorts, toss and turn at night, fight the majority, wrestle my subscribers out of common stocks, and beg all those who read these reports to stand on the sidelines. Now we're in the third phase of the bear market, and we've got eight years of the bear behind us. I well remember Robert Rhea's comment (during the 1937 bear market) that "every ten points down is ten points nearer the bottom".

For eight years I've warned my subscribers (and the press and audiences at lectures) that "this is a bear market and in due time the Dow and most issues ARE GOING LOWER. I never hedged. I told them I didn't care about the news, the President's promises, the hope of the Congress or the level of the money supply; a bear market was in force and stocks WERE headed lower. And lower they went. But now, in the third phase, I'm going to take a much more orthodox, Dow Theory position. I'm going to let the market prove to us that it will or won't go lower (I'll explain this further as we go along).

First, let's put a few facts into perspective. The broad unweighted averages such as Value Line Composite are down around 75% from their peak. That's an horrendous collapse any way you look at it, and it means that Wall Street has gone a long way towards discounting disaster. The Dow Industrial Average is now selling 10% below its book value, a rather rare occurrence. The dividend yield on the Dow Industrial Average is now 6.16%, not spectacular but in the high range of the past twenty years. Speculation is very minimal on all the exchanges at this point. Most of the speculative favorites of the past ten years have crashed. Volume on the NYSE is now 70% institutional, but when the bull market ended in 1966 it was nearer 70% individual. If 30% of today's volume represents the public, we can

say that the public is now responsible for around 3 to 4 million shares per day. This represents a big drop in public participation since the 1966 bull market top.

Margin debt on the NYSE has dropped from a peak of around $8 billion to a recent $4 billion. This is a substantial decline; maybe not enough for a bottom, but a big drop. Psychology regarding Wall Street and the economy is turning blacker by the week. Our politicians are now using the word "recession" and a few are even daring to use the word "depression". In fact, the Democrats are whipping out memories of the 1930's as they vie with each other regarding dire predictions for 1975. The news is an endless scoreboard of layoffs, punctuated with economic control threats, Justice Dept. monopoly attacks, corporate troubles, falling sales, a possible war in the Mid-East, and on and on.

Meanwhile, the market's technical position is slowly building up. We have years of odd lot selling behind us, a record short interest position on the NYSE, eighteen (!) years of decline in the advance-decline ratio, a complete dearth of secondary offerings. Many former bullish advisors and many neophyte market analysts are now openly predicting "350 to 400 on the Dow". A recent poll shows that 46% of the American public are expecting a depression.

"OK, OK," you cut in, "But what are you really trying to tell us, Russell? Are the good times ready to roll?" That is hardly what I'm saying, but I am saying that I'm going to talk less and listen more (to the market) from here on. Somewhere in this third phase, Wall Street is going to have discounted the very worst that can be seen ahead. That place may be Dow 250, Dow 400, Dow 535, or it may (yes, it is just conceivable) have been Dow 584.56 recorded on October 4, 1974. Mind you, I "think" the Dow should go lower, I think the Dow should or could go down to the 450 to 525 level or even below that. But I'm less and less interested in my own preconceived notions from here on — and more and more interested in scrutinizing the market itself (without benefit of what I think "should" happen).

Now turn to the long chart on Page 1. Not that I have pictured four leading stock Averages (ratio scale), the D-J 40-Bond Average, the advance-decline ratio and my own Primary Trend Index (PTI). I have listed the bear market lows for each of these important barometers below.

D-J Industrial low recorded October 4, 1974, at 584.56.
D-J Transport low recorded July 7, 1970, but the recent low was recorded October 3, 1974, at 125.93.
D-J Utility low recorded on September 16, 1974, at 57.93.
S & P 500 low recorded October 3, 1974, at 62.28.
D-J 40-Bond low recorded October 3, 1974, at 64.13.
A-D ratio low recorded on October 3, 1974.
Primary Trend Index low recorded November 21, 1974, at 167.

Two comments: the extreme Transport (bear market) low was recorded four years ago. The longer the elapsed time following a point in the Average, the less significance that should be given that point. Many people feel that it is a point of strength that the Transports have not yet broken their 1970 extreme bear market low. I do not agree. That low of 116.69 could well be broken in the period ahead. When it is broken, the bear market could be nearly over.

Next comment: the 40-Bond Average hit a low simultaneously with the stock Averages on October 4. Usually, the Bond Average will hit bottom weeks or months before the major stock Averages. I am somewhat suspicious of the simultaneous lows, and I would be more impressed if the stock Averages broke to new lows in the period ahead while the Bond Average held its 64.13 low.

But here is the real point of the new front page chart and my current attitude towards the market. Let's watch the news, and let's watch the bear market points listed below and on the Page 1 chart. If the news turns blacker (and it probably will), it will be crucial to note whether those listed lows hold. If they don't, well obviously, the bear market is continuing. But if they do hold, it will mean that the bear market has discounted the worst that can be seen ahead. Such action (holding in the face of horrendous, shocking news) will indicate that the bear market is exhausted, it is ending, and that the primary trend is turning from bear to bull.

But remember, the market will reveal itself WHEN IT IS READY. We can't hurry it, we can't change it. I've been writing these reports since 1957, and Wall Street has yet to produce an easy free ride or a Christmas bonus for Richard Russell or his subscribers. All we can do is watch for the evidence, and accept it or reject it (or worse still, argue with it) when it arrives.

I know that many "wiped-out" investors are finally turning bearish in this area. I know that many investment advisors have finally thrown in the sponge as far as the market is concerned. When investors sell out at a loss, when advisors sit back to lick their wounds, they harbor resentments. And they are very apt to develop a vested interest in the bear side ("I lost my money and my reputation, but if the bear market goes a lot lower, I won't look too bad").

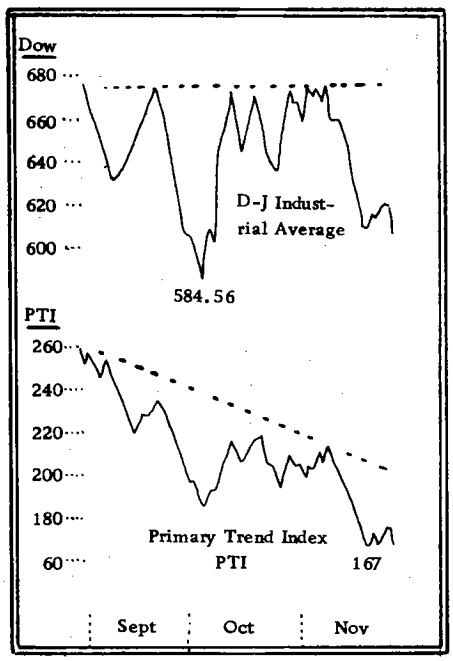
Personally, I want no part of that kind of thinking. It represents self-deceit and pride of opinion. As the great Dow Theorist, William Hamilton put it, "Pride of opinion has caused the downfall of more men on Wall Street than all the other factors taken together."

Now your next question may be, "Russell, what if the October 4 low of 584.56 for the Dow was THE low? Maybe that was the bottom, and almost nobody but the perpetual bulls knew it. If it was, shouldn't we be buying?" A good question, and my answer is this:

I don't think that was the bottom, but IF it was, I have a number of technical indicators which will give us the word. First, if October 4 was the beginning of a major primary bull market there is no great hurry to rush in. If this is really a bull market, it should last at least a number of years, and this is only December, 1974. No great bull market ever ran away within a month or so of the bottom. Remember, Wall Street is always there (the same cannot be said of investors' bank accounts, unfortunately).

I use two very important technical devices which I believe will signal the real turn. One is the three moving averages of the Dow, last shown in Letter 612, Page 3. The majority of all important rises in the Dow come after the 13-week moving average of the Dow crosses above the 50-week MA. These two moving averages are now a whopping 132 points apart! Thus, we have time here.

The second long-term timing device is my 34-week momentum line of the Dow. This line has been declining on a trend basis for four years or ever since 1971. I believe that when it turns up (in conjunction with a bullish crossing of the 13 and 50 week moving averages of the Dow), we will have an extraordinarily powerful buy climate. In a nutshell, "We ain't there yet." (Note: both the momentum index and the moving averages of the Dow will be shown in forthcoming issues).



NEAR-TERM: December tends to be a holding or rallying month for Wall Street. And when the market puts on a rotten performance right into October (as this year's market did), the odds favor a "cessation of hostilities" on the Street or even a decent rally through December.

After the ghastly performance of 1974 and the fractured rally of early October, the expectation would "normally" be for a market push at least into January of the new year (even a bad market should be capable of that much). But if a rally is to occur, we will have to see better action in the Primary Trend Index (PTI) and the most-actives. The PTI (see chart) is still diverging with the Dow, having dropped into new bear market territory on the latest dip. This kind of action, if it continues, will exert a steady downward force on the Dow despite any and all temporary spurts and rallies. On November 29 the cumulative most-active stock index dipped to within one point of a new bear market low. Such action indicates distribution, and that too will have to reverse itself if we are to get even a respite from downside pressure.

Again and again during 1974 the PTI and the cumulative most-active index said "danger" while most of the analysts were promising sunrises and rainbows. At present, they are saying caution, and both of these indices will be watched closely in these reports as we move along.

GOLD: Time is running out on any attempt to put off legalization of gold. I don't think today's Congress, at this late date, would "extend" legalization, except in the most dire emergency. In view of that, let's examine the good and the bad for gold.

The bad is the potential pressure on bullion. If it arrives, it should come from the direction I have been warning about for months. That warning concerns the coming panic for cash — and the dumping of anything and everything to raise cash. Such action will mean higher interest rates, skidding bond prices, shock on Wall Street — at least for a while.

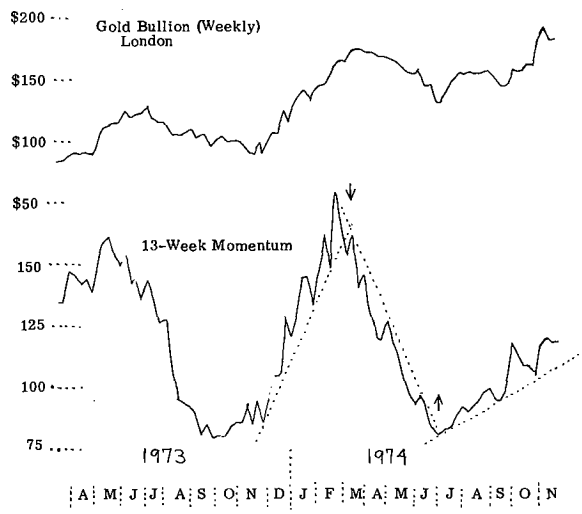
The plusses for gold are as follows (1) US legalization of gold which means US citizens buying gold, banks and institutions buying gold to build up wholesale inventories. I hear that many banks have ordered one or more tons of gold in order to be ready for the "big retail action". (2) The second big plus for gold should be the immensity of the coming US budget deficits. With the Government tax-take about to slump and with spending by Government still rising, the deficits should be absolutely breath-taking. Result, further destruction of the dollar, and hedging in gold. Here's an example of what "could" happen: if every tenth American bought one ounce of gold in 1975, such buying would take up half the Free World's gold production for the year.

While I am at it, I might as well state that I do not advocate buying gold bullion over coins. I have all along and still do advocate buying gold coins of the low-premium variety, the Hungarian and Austrian Coronas and the Mexican pesos. The Krugerrand will be legal on January 1, but I would not pay the going 17% premium for this coin. I feel that S. Africa will, in time, be putting 50% or more of its production into Krugerrands, and the premium on this coin should come down. In general, it is well to remember that gold coins will be squirreled away by consumers, taken off the market, hidden, put away for the grandchildren. Thus, coin-buying will result in the consumption AND DISAPPEARANCE of a huge amount of gold. This too is a big plus for gold.

Rule #1 for coin buying — use a reputable dealer and one who is well-financed. Such a dealer will usually keep a market in the coins he sells, and will buy back coins as well as sell them. I feel that the market for gold coins should be much more liquid than that for gold bullion, where the problem is always, "Whose bullion, what pureness of content, and does it need assaying?"

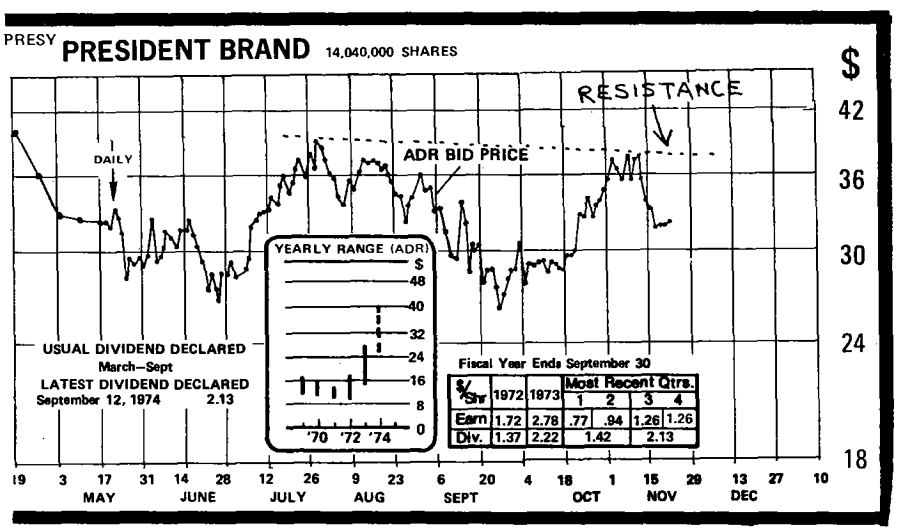
As to the technical position of gold, the gold momentum chart (Page 5) shows the momentum line holding well above its rising trendline, and for the coming week bullish momentum will be intact as long as the London price remains above the 176 level. What happens if, for the sake of argument, the gold price drops to 175, then drifts lower? I would say that such action would warrant selling of shares (not the coins), and in this case I would sell the shares down to the level where they constituted less than 20% of total assets.

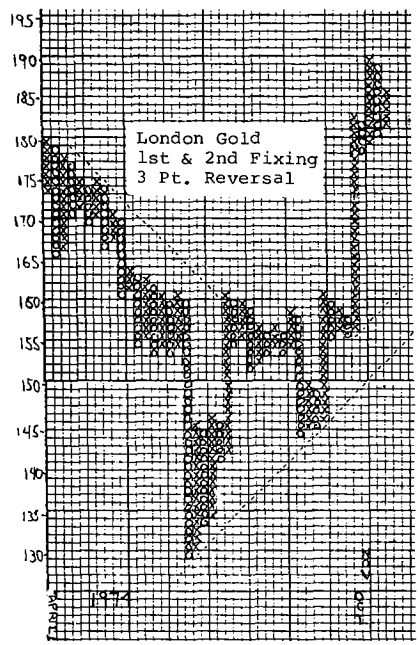
Every sophisticate now has his own "brilliant scenario" for gold. Maybe the contrary opinion is that gold will simply do what it's supposed to do, or push through $200 into the $220 area without fooling all those "poor little odd-lotters". My point-and-figure chart (three point reversal) worked beautifully on the breakout in gold above the $160 level (see Letter 613). As seen on the chart, a triangle has formed in the 178-190 area. Anything above 190 should send gold over $205, according to my chart.



At "over $200 gold" I would start scaling out of more gold shares, and I would reduce gold share positions to the point where my combined gold coin and gold share position was 25% of total assets (maybe half coins and half stocks). I don't care if this procedure means taking profits or losses or both (obviously old gold share buyers are going to have many huge profits while late buyers are going to have some losses.

At this point, I expect people to ask, "Russell, I thought you were a gold bug! Now you're saying again, 'reduce positions'." The answer is that I've been recommending gold shares ever since 1963, which is about eight to ten years longer than anyone else (with the exception of Jim Dines). I've never been a bug on anything but correct market procedure, and my charts, my market sense, my intuition, and my common sense now say , "take it easy". It's often a good idea in this business to be where everybody else ain't. More and more, it's occurring to me that nobody's got any debt-free cash. Nobody's got liquidity. Cash is where everybody isn't. It might be an increasingly interesting place to be.





In the last report I reviewed the chart patterns in a number of the S. African gold shares. As a rule, they will all tend to move in the same direction with the better mines obviously performing best. I include here a chart of President Brand, a stock which I first recommended years ago at 9. We do have a potential bottom here with a resistance line (shown on chart) at around 38. If Pres. Brand can now muster the strength to push over the 38-40 area, it would mean to me that the entire S. African gold group was taking on new life. Obviously, a breakdown from here into the below-30 area would be disappointing. This single stock (which I have picked more or less at random) will tell us a lot about the whole gold group in the period ahead (chart courtesy of Kaffir Chart Service, Palisades Pk, NJ 07650).

NOTES & QUOTES: Wall Street's bank accounts may be heading lower, but their souls are elevating, as noted in this clip from last week's Los Angeles Times. I assume that Trinity Church will empty out again in the next bull market (could this be a new indicator?).

The chief of the thundering herd (remember that frothing herd of bulls tearing across your TV screen?), Mr. Donald T. Regan, Board Chairman of Merrill, Lynch, spoke last week. He said the recession was gathering momentum and packing a "stronger punch" than most economists were aware of. "All in all, then, I see some rather grim months immediately ahead of us," said Mr. Regan. I suppose we should elect Regan to this week's "Better Late Than Never" Dept.

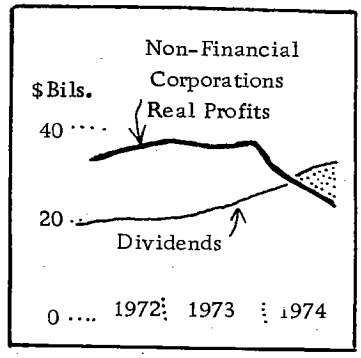
In what appears to be almost a complete about-face from its long-held bullish stance, Business Week magazine is now belting out the facts. In the latest (Nov. 30) issue they put forth a

NEW YORK—Wall Street is praying—literally—for a stronger stock market.

Officials at the Parish of Trinity Church, which covers the heart of New York's financial district, say the number of Wall Streeters praying at the noon mass has just about doubled.

And, according to clergy at Trinity Church and St. Paul's Chapel, the two churches in the parish that serve the Wall Street community, there are more individuals from the financial community sitting in pews meditating at all hours of the working day.

thesis which I have been warning about for months, namely, 1975 could be the year of the big dividend famine. Noting that total real corporate profits (profits minus inventory profits) have "been plunging all year," BW states that third quarter profits of all corporations were at an annual rate of $25.2 billion while dividend payout was at an annual rate of $33.2 million. Thus, we have a dividend shortfall of $8 billion! What will happen? Corporations will try to raise cash by unloading inventories, rushing to the bond market, slashing dividends. Two results, higher bond yields and slumping commodity prices (the latter resulting from distress inventory dumping).



Commodities are coming down now, with the major commodity indices looking toppy, very toppy. Sugar, which was almost single-handedly holding up the D-J Commodity Futures, has been tumbling the limit day after day. The Commodity Research Bureau's very representative index of 35 commodities looks as if it has formed a giant head-and shoulders top. If so, the various commodity indices should soon look like the 1973-74 stock market.

LATE THOUGHTS: The Dec. 2 Wall Street Journal (front page) comments about the strange spectacle of corporations pouring into the bond market to raise money in the face of slumping business. This is the beginning of the "money panic" which I have been warning about. On page 26 of the same issue chief economist Finn of the SEC notes that the corporate debt-to-equity ratio is now 42% against 21% twenty years ago. He fears that as the economy slows, this lack of liquidity will prove "the final straw" for some companies. That, I believe, is putting it mildly. I foresee a positive frenzy for cash (I'll say it again) as company after company tries frantically to stave off bankruptcy. This kind of action is going to produce the third phase of the bear market, the liquidation phase. It is also probably going to have a temporarily adverse effect on gold (you can sell gold and gold shares to raise money, just as you can sell houses, stocks, stamps, art objects and anything else).

I have been saying that by 1975 inflation will be the forgotten word, as far as prices are concerned. When sales volume starts slumping, the price structures are going to buckle. It's all beginning now, and I expect matters to accelerate. All of this is developing about the way I thought it would, and I am not alone in my thinking. The black news is now coming out, but it should hardly surprise readers of these reports. So again I want to remind and warn my subscribers of one thing — THE STOCK MARKET DISCOUNTS. TODAY'S NEWS IS HISTORY!

DREARY THOUGHTS: This hasn't much to do with bull or bear markets or making a buck on Wall Street. But I do have many thousands of subscribers and numbering among them are some of the wealthiest, most intelligent and most influential men and women in the nation. And I guess I have fantasies that maybe something I write here will click with one or more of my readers, and that something, somehow, will emerge from it all. The fact is that the political situation here and around the world is growing so foggy, so unstable, so rudderless that it boggles the mind. The news clip at right points to a US society which is drowing in debt plus the cost of carrying that debt.

As of Nov. 21, the federal debt was $483,567,000,000 and the government was paying an average interest rate of 6.761 per cent on it.

In fiscal 1974, interest on the federal debt cost a whopping $29.2 billion. For the current year it is expected to hit about $33 billion, a sum equal in current dollars to the entire federal debt after four years of President Franklin D. Roosevelt's New Deal.

And that this point I do not know of anything which can keep this system going except a severe purge, a deflationary purge which will build up liquidity throughout the system again. That's the real kind of sacrifice this nation needs if the current system is to last. "Never," I am told, "the people would never stand for the pain and suffering of a massive deflation." Tell a man with gangrene that he is going to lose his leg. "I'd rather die," he screams, "don't touch my leg, I'd rather die." "It's your choice," says the sad-eyed doctor, "but at this point it is a choice, the pain or your life, decide."

For many years the tide of gathering inflation has been apparent to anyone who had eyes. Yet the apathy and ignorance of the American public and the stupidity and arrogance (plus greed) of the politicians allowed the inflation to continue. A sign of maturity is the ability to put off current pleasures for future well-being. Under that definition, the US has been a gurgling infant. I know of no society in the history of the world which has held intact under the forces of accelerating inflation. If the authorities in Washington now fail to "lay it on the line" to the American public, if they fail to halt public spending, if they fail to hold the deficits to a minimum, then this system as we know it is heading towards the sunrise.

The history of the rise and fall of nations can be written in the rise and fall of their currencies. For thousands of years the gold-accumulators have been the rising world powers, while those who have lost their real money (gold) have been toppled from prominence (the path of gold is merciless and the reasons for the gold movements are academic). I have been warning about this for years, now it is happening. Why have there been no imaginative American leaders, why have we produced such dismal Presidential material, why? Perhaps George Washington gave us the answer when he said, "Few men have virtue enough to withstand the highest bidder."

WIND-UP: (Written Mon., Dec. 2, after the NYSE close). December started with a thud, Dow down 15 points, Transports and Utilities in toppy formations (see WSJ chart of Averages). Momentum turning down on my daily T-bill yield chart, also turning down on my $4\frac{1}{4}$ Treasury bond chart. This taken with the sinking Utility Av. could mean tighter money; if so, we're moving into the cash squeeze.

RECOMMENDED place for cash in any amounts over $1,000 – Capital Preservation Fund. Jim Benham, President, has fund entirely in short-term Government issues, it's the most conservative of the money funds. Address: 459 Hamilton Avenue, Palo Alto, CA 94301.